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Nos. 415, 416

In the Supreme Court of the United States

OCTOBER TERM, 1970

UNITED STATES OF AMERICA, PETITIONER

v.

WATERMAN, LARSEN & CO., INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES W. AND DOROTHY F. STEADMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES AND THE COMMISSIONER

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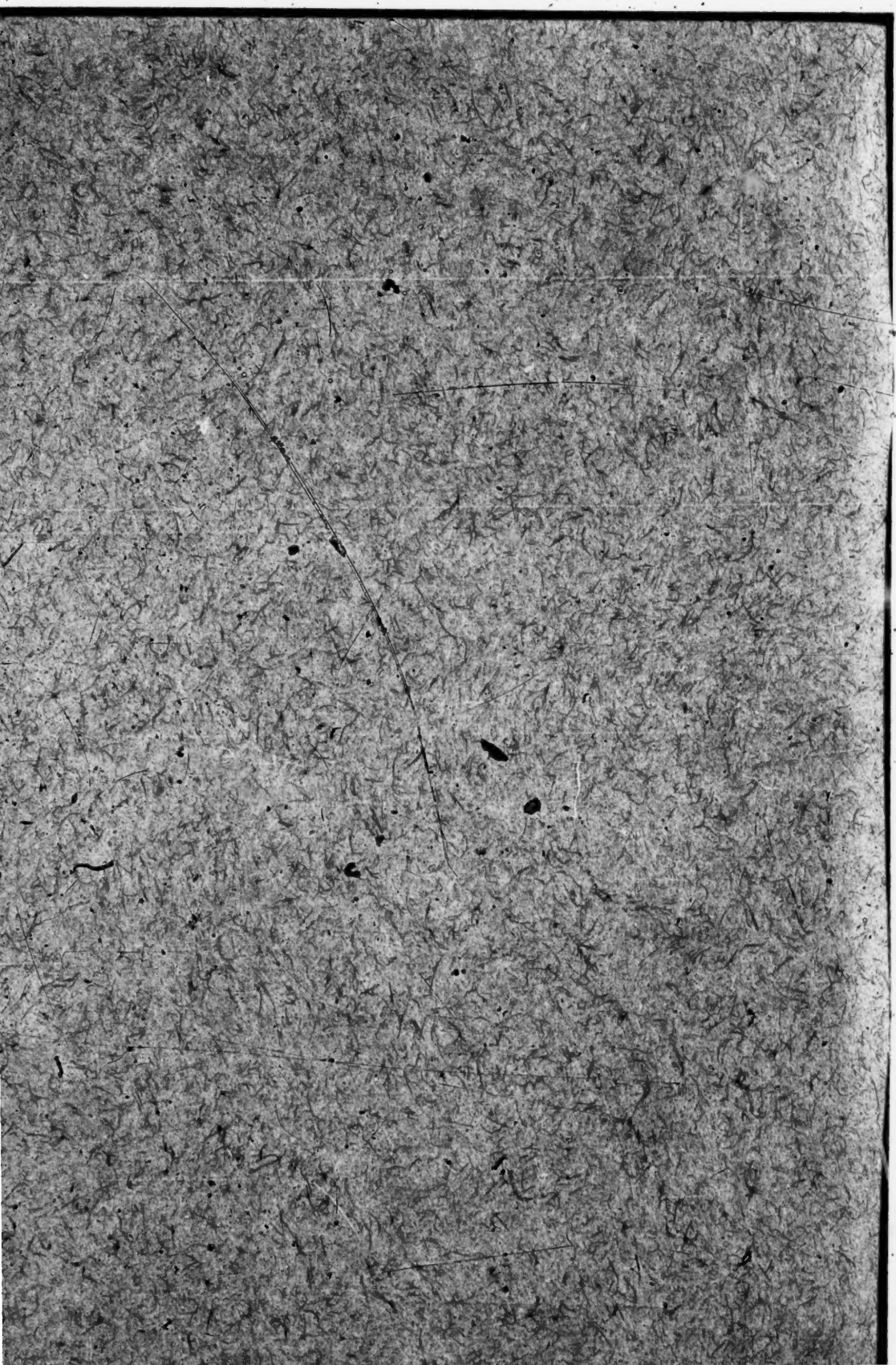

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1. The briefs in opposition in these cases themselves demonstrate the need for prompt review and correction by this Court.

Respondents concede (Br. (No. 415) 8; Br. (No. 416) 10) that they acquired capital interests in corporations; Waterman, Largen concedes (Br. (No.

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415) 5–6) that the Court of Claims' construction of *Corn Products Co. v. Commissioner*, 350 U.S. 46, cannot be squared with the language of Section 1221, which says in the plainest terms that the characterization of an asset as capital or non-capital is to be made without regard to whether that asset is connected with the taxpayer's trade or business. It also concedes (Br. (No. 415) 11) that the lower court applied the standards of Section 166, relating to business bad debts, even though that provision has no bearing whatever upon losses on the sale of stock. Steadman concedes (Br. (No. 416) 8–9) that the Sixth Circuit in effect applied the standards of Sections 1231, 1242 and 1244—standards allowing taxpayers capital treatment on gains and ordinary treatment on losses in carefully delineated circumstances—despite the fact that those provisions admittedly are inapplicable here.[1]

After all these concessions, however, respondents oppose review by this Court. They do so on the ground (Br. (No. 415) 6–8, 10–11; Br. (No. 416) 7–8) that the issue in these cases is factual in nature. But the issue here is whether the capital asset provision—Section 1221—is to be read out of the income tax law in cases where corporate stock

[1] Steadman asks rhetorically (Br. (No. 416) 8–9) why different rules should apply to his depreciable law books, on the one hand, and stock purchased for a business purpose, on the other. The answer is that Section 1221(2) excepts depreciable property from the definition of a capital asset if it is used in a taxpayer's trade or business; it does not except capital stock from that definition "whether or not connected with his trade or business." In short, Congress has provided one rule for depreciable business property and another for stock.

is acquired for a "business purpose." That is clearly a legal issue.[2] One need read no further than the "Statutes Involved" portions of the briefs in opposition (Br. (No. 415) 1–2; Br. (No. 416) 2–4) to confirm this, for neither respondent has cited Section 1221, which is captioned "CAPITAL ASSET. DEFINED." Moreover, there is no dispute as to the salient underlying facts. All that remains for this Court to decide is whether a "business purpose" for a stock acquisition can convert that stock from a capital into a non-capital asset.

2. In No. 415, three business entrepreneurs organized and capitalized the Elmvale-Laurens corporation and owned its capital stock. Each had an interest in a long-term venture; each had a particular reason for investing. Carey Kinney wanted (Pet. (No. 415) App. 28) "to insure his son's business future." Nichols

[2] Respondents point out (Br. (No. 415) 6–7; Br. (No. 416) 8) that, in the past 15 years, there have been a few instances in which lower courts have invoked *Corn Products* in the government's favor. From this, they make the curious and transparently incorrect argument that all purported applications of *Corn Products* must be deemed factual *regardless of the legal standard used*. In addition, in reliance on the same cases, they dispute our contention (Pet. (No. 415) 14–15, 19–20) that the potentially limitless "business purpose" concept, which has come to full fruition in recent years, cannot be applied evenhandedly to taxpayers and the government alike (Br. (No. 415) 6–7; Br. (No. 416) 8). But, in this regard, respondents fail to cite a single case other than *Hollywood Baseball Association* v. *Commissioner*, 423 F. 2d 494 (C.A. 9), taxpayer's petition for certiorari pending, No. 157, this Term, in which the government has prevailed under a *Corn Products* rationale in the last seven years. Moreover, as we show in our brief in opposition in *Hollywood Baseball*, the *Corn Products* rationale was not essential to the result reached in that case.

Fiber wanted (Pet. (No. 415) App. 29) to "continue as the raw material supplier." Waterman, Largen wanted (*ibid.*) "to become sales agent for the mill's entire production." In No. 416, Steadman furnished permanent capital to a financially troubled client corporation (Pet. (No. 416) App. 14) "to protect his position as general counsel for Richards Music and the earnings necessarily flowing from such position." The notion that these diverse business motivations rendered the entire investment in Elmvale-Laurens and Steadman's investment in Richards Music non-capital in nature is completely foreign to the tax statute. Yet, this notion underlies the holdings below.

To avoid the rules that are applicable to capital stock, respondents argue (Br. (No. 415) 8–9; Br. (No. 416) 10–12) that they should be treated as having acquired other assets under the step-transaction doctrine. But that doctrine may properly be invoked only when the stock is acquired merely as an interim step in obtaining another asset. Thus, in *Western Wine & Liquor Co.* v *Commissioner*, 18 T.C. 1090, and in *Kimbell-Diamond Milling Co.* v. *Commissioner*, 14 T.C. 74, affirmed *per curiam*, 187 F. 2d 718, certiorari denied, 342 U.S. 827, the taxpayers sought specific assets owned by the corporations whose stock was acquired and had no interest in the continuance of the corporate ventures. They promptly extracted the desired assets and discarded the stock. In contrast, Waterman, Largen and Steadman were interested only in the continuing existence of Elmvale-Laurens and Richards Music, respectively, and in the latters' continuing success. Respondents did not acquire their

stock as a transient measure or an interim step in the acquisition of other assets, but rather to keep it for the long term. Their assertion that the step transaction doctrine applies in these circumstances to transcend their ownership of capital stock represents a clear perversion of that doctrine.

It thus makes no difference that Waterman-Largen might have received ordinary, rather than capital, treatment if it had sold a right to future brokerage commissions (Br. (No. 416) 8-9), or that Steadman might have received such treatment upon a sale of the "thing" he says he bought (Br. (No. 416) 11)—"a continuing source of legal fees." Since respondents purchased nothing less than full ownership rights in corporations,[3] and since they cannot be treated as having acquired other assets under the step transaction doctrine, the transactions here in question must be tested and taxed in accordance with the rules applicable to capital stock.[4]

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[3] This is particularly clear from the evidence in *Waterman-Largen*. Carey Kinney insisted (Pet. (No. 415) App. 29-30) that respondent "should have a substantial financial interest in the mill" so that the relationship would be "in the nature of a joint venture."

[4] Steadman argues (Br. (No. 416) 7) that the government's position is inconsistent with Treas. Reg. 1.1221-1, which provides that the holding period of an asset is not to be taken into account in determining its character. But the length of the holding period of stock is relevant only in determining whether the taxpayer should be treated as having acquired stock, or whether the stock acquisition should be considered an interim step, so that the taxpayer is deemed to have acquired an underlying asset. Once it is determined *what* asset the taxpayer is to be treated as having acquired, that asset is to be *characterized*, in accordance with the regulations, without regard to its holding period.

3. Only infrequently does the government find itself constrained to seek certiorari in tax cases which raise no conflict with a decision of another court of appeals. These petitions are unusual ones, predicated on what the government regards as an urgent need for reversal of the decisions below because the questions of statutory interpretation and application involved are basic and far-reaching. Respondents assert (Br. (No. 415) 12; Br. (No. 416) 9–10) that, for this purpose, Congress, rather than this Court, is the appropriate forum. However, a congressional amendment to the Code is not needed to require capital treatment in these cases. It is respondents, not the government, that ask that the present capital asset provision be scrapped.

Respondents tell us (Br. (No. 415) 6; Br. (No. 416) 8, 10) that the *Corn Products* principle is clear-cut and easy to apply. The commentators say the contrary. (See Pet. (No. 415) 15 n. 8 & n. 9.) Respondents tell us (Br. (No. 415) 8–10; Br. (No. 416) 8) that review by this Court would serve no purpose, that this Court's consideration of the issue would give rise to as many problems as it would solve. But the question is clearly a recurring one on which this Court's guidance would be useful to the lower courts. And, a reaffirmation by this Court of the basic principle that the step transaction doctrine may be applied only where one asset is acquired as an interim step in obtaining another would, in and of itself, resolve most of the problems raised by the *Corn Products* doctrine.

The lower courts have had 15 years of experience under *Corn Products*. During that time, they have

misunderstood its holding and, more recently, culminating in these cases, have expanded that holding beyond recognition. The point has now been reached where, absent elucidation by this Court, there is no longer a realistic prospect that *Corn Products* will be properly interpreted in the courts below. We urge, therefore, that the Court hear these cases and clarify the law.

Respectfully submitted.

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